Improving the Policy Response to Financial Crisis

Remarks by Agustín Carstens,
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at the
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It is a pleasure and an honor to have the opportunity to address such a distinguished audience at this international conference that celebrates the 60th anniversary of the creation of the Bretton Woods institutions. At the outset, I would like to thank the Banco de España for its superb hospitality and for the very close collaboration with the IMF in putting all of this together

During the last 60 years, the Fund and its member countries have been struggling with the challenge of improving the policy response to financial crisis. As many of us know quite well, when a crisis occurs, resolution is far from an easy task. Ideally, policy measures will aim to limit disruptions, stabilize the economy, and lay the groundwork for the resumption of long-term growth. Yet, the policy response involves difficult judgments and unpleasant tradeoffs amid significant uncertainty. Measures may have temporary side

effects and—especially if reforms are not fully carried through—a country can remain exposed to significant post-crisis vulnerabilities.

It is striking how, over the last thirty years, crises in many countries have become recurrent. Recent research we have undertaken at the Fund shows that this is particularly true in Latin America. Since 1980, 22 Latin American countries have suffered either a financial crisis or financial distress, in the latter case narrowly averting a full-blown crisis. Of these 22, three countries have experienced four episodes each; three countries have experienced three episodes each; and nine countries have experienced two episodes each. For example, Argentina has suffered four crises, in 1980, 1989, 1995 and 2001. Ecuador suffered three crises, in 1982, 1996 and 1998, and narrowly averted one in 2002. Brazil and Bolivia each experienced two crises between 1985 and 1995, and pulled back from the brink in 2002 and 2003, respectively.

I feel that more systematic research on recurrent crises is urgent. In trying to advance some ideas on the issue, I would venture to say that—all too frequently—the compromises that are made with the intent of *resolving* current difficulties may actually sow the seeds for the next crisis.

Accordingly, I would like to focus my remarks today on **four issues**, which I think are critical for the international community to better understand our efforts to improve the policy response to financial crisis:

- first, the complexities involved in designing an appropriate policy framework;
- second, the “ugly” tradeoffs policy makers face in formulating policy options;
- third, the post-crisis vulnerabilities that might remain and the need for countries to persevere in their efforts to reform and to “crisis-proof” their economies; and
- last, the role of the Fund in this context.

First, consider how difficult it is to identify the appropriate policy framework. There is uncertainty regarding the scope and impact of a crisis. In the midst of a crisis, key macroeconomic variables tend to display unusually high volatility. The resilience of the economic system and the severity of the crisis are uncertain. As a matter of fact, once a crisis has erupted and the Fund’s mission starts its groundwork, it is not uncommon that preliminary assessments need to

be revised as, in a crisis environment, hidden liabilities—both public and private—can pop up like rabbits out of a hat.

Balance sheet interlinkages across sectors of the economy can amplify weaknesses in individual sectors and propagate a crisis across sectors, to the balance of payments, and to the sovereign. Such interlinkages may complicate the policy response and magnify the costs of crisis resolution. There is also uncertainty regarding the effectiveness of policies, which depends critically on the perceived credibility of the corrective measures when the reputation of the authorities tends to be at its lowest level. And there is uncertainty regarding the political support for reforms. Policy makers face the additional challenge of quickly mobilizing public support for often unpopular measures.

Against this background of economic and political uncertainty, the policy response is often subject to “ugly” trade-offs. A prime example is the fiscal consolidation that may be required to reduce imbalances or debt burdens. This must be sufficient to strengthen confidence in the sustainability of public finances, but not so much as to undermine medium-term growth prospects.

In cases where a banking crisis is part of the problem—such as the recent crises in Argentina, Turkey and Uruguay—public support will likely be required to safeguard the functioning of the domestic financial system. But this support can exacerbate debt sustainability concerns and make the previously mentioned tradeoff even more difficult. Moreover, in extreme situations, administrative measures may be seen as unavoidable for quelling a banking crisis—although these risk eroding confidence in the banking system and triggering capital flight and financial disintermediation.

In cases where sovereign debt restructuring is needed, the benefits of alleviating the liquidity or solvency constraint must be weighed against the implications for future access to capital markets. In addition, policymakers may need to factor in the potential costs to the domestic financial system if bank portfolios are significantly exposed to government debt.

Next, consider how—even if a credible adjustment quickly restores confidence—a number of vulnerabilities can linger and perhaps even increase. Public finances may remain vulnerable to shocks. If public debt remains at high levels, gross financing requirements continue to be large, and thus vulnerable to

shocks or spells of market drought. Banks may remain vulnerable to debt servicing difficulties of household and corporate sectors, or because of a large exposure to sovereign debt. And in cases of sovereign debt restructuring, a country may lose access to markets for a prolonged period of time.

Perhaps most importantly, there is always a danger of “reform fatigue.” As countries move out of the critical stage in the process of crisis resolution, it is not unusual to see some of them lose their drive towards reform. Several factors contribute to this: a) the erosion of political capital; b) an early positive response from investors that might lead to complacency; and c) the fact that many of the needed reforms do not induce immediately higher growth and wellbeing of the population. But here is precisely where the recurrent crises have their genesis. Once the most urgent measures have been implemented, the tendency is to put aside the important ones for later. The message is clear: it is critical that countries persevere with reforms to “crisis-proof” their economies and avoid recurrence of financial distress.

Finally, let me say a few words about the role of the IMF in crisis resolution, and how we are working to improve it. A key role of the Fund is to work with

members to achieve a durable exit from crisis. The Fund helps members to consider the relevant constraints and trade-offs and to design an appropriate adjustment program that addresses underlying macroeconomic problems, as well as anchors investors' expectations about the formulation and implementation of economic policies. In helping to design this program, the Fund has to form a judgment about the appropriate balance between the availability and scale of IMF financing, the amount of domestic policy adjustment, and securing the support of other stakeholders (official and private creditors). And in forming this judgment, the Fund must also consider the implications a crisis country may have on the stability of the international financial system.

Based on previous experience, we are continually examining policies that could help reduce the frequency and severity of crises. We are focusing on several issues at present, including reinforcing the rigor of our debt sustainability analysis, especially through a more thorough analysis of contingent claims. We are working to raise awareness of balance-sheet vulnerabilities, to ensure that risks are properly assessed and effectively addressed. We have taken steps to improving clarity about IMF lending decisions, especially with regard to the

situations when exceptional access to IMF financing may be appropriate. And we are working to improve the process for restructuring sovereign debt within the existing legal framework. This includes encouraging the use of collective action clauses (CACs) in new sovereign bond issues, as well as supporting private sector efforts to formulate a voluntary Code of Conduct.

Strong banking systems are a foundation for financial stability. Therefore, we have been working also with the Basel Committee and its chairman, Governor Caruana, in encouraging emerging market countries to move towards the adoption of the new set of standards embodied in the Basel II Accord, ensuring that this transition occurs at their own pace and based on their own priorities.

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Ladies and Gentlemen,

Notwithstanding all these efforts, there is no doubt that substantial challenges are still in front of us. Therefore, in closing, I would like to commend the organizers of this conference for bringing together distinguished economists and policymakers that through their interventions will shed some light on the critical issues involved in building a more stable international financial system. Yet our main challenge will be to put all of these ideas together, into a coherent

strategy for crisis prevention and resolution that is both effective and durable. If we can do this, we may also be able to abate the recurrence of crisis.

Thank you.